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SUBJECT: Clark and Subic Freeports Sound but Slowing

REF: a) Manila 85; b) Manila 86; c) 08 Manila 2740; d) Manila 108;
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¶1. (SBU) Summary: The former American bases at Clark and Subic Bay have become successful "special economic zones," a designation for areas with relatively attractive investment regulations. They benefit from their excellent transportation facilities and the country's English-speaking, educated work force. Shipyards and related services are the most important industries at Subic, while Clark hosts business process outsourcing, semiconductors, and tourism. Clark and Subic are examples of the successes and challenges of the special economic zones. Nationwide, the zones account for 80% of Philippine exports. Their friendliness to capital has attracted billions of dollars of investment. However, the integration of the zones into the global economy, the key to their success, also renders them far more vulnerable to the impact of the global economic slowdown than the rest of the Philippine economy. They will see significant layoffs over the coming year. Further, there is some question whether they truly benefit the country in the long run. End summary.

From Ghost Towns to Export Centers

¶2. (U) When the United States closed the Clark Air Force and Subic Naval bases in 1991, many observers predicted that the two would become ghost towns. Instead, the GRP enacted the Bases Conversion Development Act in 1992, turning the former bases into special economic zones with their own more attractive legal and more effective governance structures. Clark, Subic, and other special economic zones now produce 80% of Philippine exports, and are the most important areas of Philippine integration into the global economy. The most dynamic sectors of the country's economy dominate the zones, including business process outsourcing, tourism, shipbuilding and maintenance, garments, and electronics. The zones remain sound and strong. Foreign investors are overwhelmingly happy with how their businesses have been performing, and report that the zone authorities play a highly constructive role. The industries in the zones draw on the Philippines' most significant advantages, including its English-speaking, educated labor force and the country's proximity to global manufacturing supply chains.

¶3. (SBU) The praise of the special economic zones contrasts sharply with foreign investor criticism of investment possibilities in the rest of the Philippine economy. The domestic economy in the Philippines is heavily protected, controlled by a handful of dominant and politically-connected families, and generally inefficient, marked in particular by low rates of both foreign and domestic investment. There are serious legal and governance deficiencies (ref A and B).

¶4. (SBU) Relative isolation from the global economy has sheltered most of the Philippine domestic economy from the global slowdown (ref C and D). Domestic businesses will be affected by the slowing of growth in remittances as overseas Filipino workers lose their jobs, and by the reduction in consumption resulting from layoffs in the zones (see below) but otherwise, the domestic economy appears to be rather insulated from international economic trends.

¶5. (SBU) Export zones like Clark and Subic, on the other hand, are extremely vulnerable to the current global recession. In particular, manufacturing at Clark and Subic is pro-cyclical; i.e., it thrived in the economic boom of the first two-thirds of this decade and has been among the first to suffer from the falloff in worldwide demand. While investors maintain that they are committed to the zones for the long term, they also expect the next year or two to be difficult, with projects delayed or canceled, and with many workers losing their jobs.

Subic's Shipping Focus Endures

¶6. (U) Subic Bay was not only the home of the U.S. Seventh Fleet, but also the location of the yards that carried out repairs to U.S. Navy vessels in the Pacific. This legacy has led to the emergence of a number of businesses servicing world shipping. Most notably, the Korean firm Hanjin Shipping, has built a major shipyard in Subic that employs 20,000.

¶7. (SBU) Hanjin is Subic's largest employer, but has suffered from the impact of the downturn in shipping. Lease rates for cargo ships have fallen to a fraction of what they were a year ago, causing

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shipping lines to cancel orders for new ships. A Hanjin engineer told EconOff that contracts to build seven ships have been canceled since September, and workers have been told to slow the pace of their work on four other vessels. Over twenty undelivered ships without buyers now sit idle in Subic Bay. The owner of a neighboring business told us that other Subic companies expect Hanjin to lay off up to half its workforce during 2009. Many dry dock businesses have also sprouted around Subic, drawing on a workforce with experience in repairing U.S. Navy ships. These businesses have been somewhat more resilient during the crisis, since ships that continue to sail must be serviced at least once every two years, but still have suffered as the volume of global shipping slides.

Clark Airstrip: Manila's New International Airport?

¶8. (U) The former Clark runway is now the Diosdado Macapagal International Airport. Given its relative closeness to Manila (about 50 miles) and room for expansion and the addition of new runways, the GRP intends to make Clark the new international airport for Manila within the next decade (ref E). For the moment, Asian budget carriers dominate flights into Clark, but the director of the airport told us that a new passenger terminal and a high-speed light rail connection between Clark and Manila within five years will make it possible for Manila travelers to reach the airport in under an hour. While the airport initially served businesses located in the Clark zone, such as the Asian hub of United Parcel Service (now slated to move to China), most of the airport's traffic now serves passengers from parts of Central Luzon outside the zone.

Texas Instruments

¶9. (SBU) In 2007, Texas Instruments announced a \$1 billion investment in a new factory in Clark, its second large facility in the Philippines. The construction has been proceeding on schedule, but it neared completion just as the world electronics market began to slow. We understand that the company remains committed to its Clark factory, but in light of the slowdown, and the recent layoff of several hundred employees in Baguio, the opening of the Clark facility will be delayed.

Korean Investors and Tourists Have a Central Role

¶10. (SBU) Within the past two months daily flights have been introduced to Korean airports. In addition to Hanjin, several tourism projects, retirement properties, luxury hotels, nightclubs, English study programs, and golf courses in the zones cater to Korean visitors, especially during the winter months of November to February. A manager at the Mimosa Country Club at Clark told us that the golf course has been practically empty this winter, as the depreciation of the Korean won by about one-third has kept most Korean visitors away. The zone's Holiday Inn, a majority of whose clientele is Korean, has also suffered a spike in its vacancy rate.

Export Zones Have Attracted Smugglers

¶11. (SBU) The smuggling into the Philippines via the tariff-free Subic Freeport was an important political issue during 2008. Petroleum and used automobiles were the most profile smuggled goods. Zone officials told us that smuggling has declined sharply over the past few months as oil prices have fallen and an executive order banning the importation of used vehicles has been more rigorously enforced.

A Single Clark/Subic Zone?

¶12. (U) A new 58-mile expressway linking Subic, Clark, and the city of Tarlac opened in April 2008, cutting the travel time by road between the two economic zones from three hours to around 45 minutes. With that, there are initiatives to market the zones as a single magnet for business, with the intention of eventually unifying the zones. The leadership of the zones has already created a joint "Clark Subic Marketing Agency" to promote the zones to investors, and they are investigating the idea of incorporating the land along the new expressway into the zones, and perhaps combining them.

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Clark and Subic Feel the Recession

¶13. (SBU) Despite the prospects for growth, this year is likely to be difficult for Clark and Subic. Businesses at both zones are feeling the effects of contracting demand, in the form of lost business and cancellation of existing contracts, particularly at the Hanshin shipyard in Subic. According to the head of the Labor Department at the Subic Bay Metropolitan Authority, there were 800 layoffs in Subic between October and December, and as of January, another 1,500 workers are on mandatory annual leave. Other businesses have resorted to various measures to reduce labor costs while avoiding layoffs, such as suspending operations for up to two months this winter, or reducing workers to 30-hour weeks. Operators of several American-owned businesses in the zones told us that their workforces embodied investments of time and training. One manager explained that a majority of his workforce had been with his company since it opened in the Philippines in 1998, and that if he had to lay people off, it would take years to rebuild and retrain his workforce once the economy improved.

Special Economic Zones: an Economic Model?

¶14. (SBU) Clark and Subic illustrate both the success and the vulnerability of Philippine economic zones. The firms that have invested there view their experiences as successes, and they intend to stay for the long term, as demonstrated by their desire to hold on to their skilled work forces despite the present slowdown. The Clark and Subic zones remain fundamentally sound, and are examples of what the Philippine economy would be capable off if it were less closed and protected. Clark and Subic have been hit by a downturn that was not of their own making. While the next year to 18 months will be difficult, they look set to be successful over the long

term.

¶15. (U) As a 2008 World Bank Study (Rising Growth, Declining Investment: The Puzzle of the Philippines) noted, the 44 special economic zones were "conceived as a substitute for a good investment climate." As such, they have been successful. However, their impact on the Philippine economy has been, perhaps, less than originally expected. The direct benefit to the Philippines as a whole seems to be mostly the consumption generated by the salaries paid in the zones, making these jobs somewhat analogous to those of overseas Filipino workers. In effect, the zones may serve as yet another escape valve of the political economy of the Philippines (ref C), allowing the low investment, oligopolistic domestic economy to delay or avoid reform -- making a good investment climate for the country as a whole less necessary and less likely.

Kenney